The Institute of Chartered Accountants of Nigeria (ICAN)

SKILLS LEVEL EXAMINATION

2019

Mock Exam

(3 hours)

Corporate Strategic Management and Ethics

Answers

Question 1

Tutorial note: *At the skills level it is not always possible to publish a suggested answer which is fully comprehensive. Credit will be given to candidates for points not included in the suggested answers but which, nevertheless, are relevant to the questions.*

The suggested answers presented below give more detail than would be expected from a candidate under examination conditions.

The answers are intended to provide guidance on the approach required from candidates, and on the range and depth of knowledge, which could be written by an excellent candidate.

(a) The PESTEL framework may be used to explore the macro-environmental influences that might affect an organisation. There are six main influences in the framework: political, economic, socio-cultural, technological, environmental and legal. However, these influences are inter-linked. For example, political developments and environmental requirements are often implemented through legislation. Candidates will be given credit for defining the main macro-economic influences that affect NS, rather than the strict classification of these in the PESTEL framework.

Political

The political environment in which organisations operate is very significant. Political parties may encourage or discourage economic activity through taxation policies and legislative programmes.

NS is based in a stable, prosperous country, where successive governments have valued and encouraged technology. Tax incentives and grants are given to companies that invest in technology and in research and development. Tax credits are also provided to companies that invest in research and development. These incentives are open to NS, its domestic competitors and its domestic customers. The government has also promoted the use of technology through a well-publicised awards scheme. NS is a recent beneficiary of such an award – for "technological innovation in data communications".

The scenario suggests that the government itself is a major investor in communications technology. This technology has to be delivered through equipment that meets certain standards of reliability and compatibility. The government has put an approval process in place to ensure such standards. Such a process should ensure that technically inferior goods do not make it into the market place.

The current political environment wishes to protect its citizens who are employees, by enacting legislation concerning employment hours, conditions and reward.

Economic

The stage or phase of the economic or business cycle clearly affects customer buying decisions. The case study suggests that 20X4 saw a downturn in the domestic economy which resulted in a reduction of customer commitment to long-term investment. Customers may postpone their buying decisions, although if innovative products bring cost and communication advantages then they will eventually have to invest in them.

Despite worsening economic conditions, labour costs remain high in Redland and the company may have to re-consider their commitment to manufacturing in the country.

Socio-cultural

It appears that electronic communication and information exchange will continue to increase with implications for companies supplying products and systems to meet these growing needs. All evidence suggests that the social use of services on such networks will increase. Hence, although demand appears to be currently dropping off, new social uses for telecommunication networks might spark off a new wave of investment.

Technological

Technology is a significant factor in shaping the life cycles of existing products and the introduction of new ones. The technology sector is extremely innovative, with new and improved technologies constantly emerging. NS must scan the external environment for such technologies and identify how they might affect the future of their current products. NS must also consider how such emergent technologies might be used in their own products. The forecast that increased sales will come from currently installed networks rather than from the installation of new networks is also relevant here.

Environmental issues

Green issues have an increasing impact on organisations, particularly in prosperous developed countries. The reduction of emissions and improvement of re-cycling are likely to be reflected in socio-cultural trends and enshrined in legislation. The cost of waste disposal is also increasing. All these issues combine to increase the costs of manufacture and affect the competitiveness of the company in its market place.

Legal

NS operates in a country where there are laws defining employer responsibilities and employee rights. It is likely that such regulation will continue and NS, like all companies working in Redland, have to evaluate the benefits and costs of working within such constraints. Some organisations seek to gain competitive advantage by moving to countries where regulation is more lax and hence avoid the compliance costs incurred by their competitors. The scenario suggests that NS has significant international competitors. It is likely that some of these will be based in countries where employment and other legislation are less onerous.

Summary

In the context of the scenario, it is political, legal and economic factors that significantly affect NS. However, as a technology company with significant investment in research and development, NS must continue to scan the technological environment to identify trends that could undermine, enhance or replace their products.

(b) Michael Porter provides, through his five forces framework, a useful way of analysing the competitive environment of NS. Analysis suggests that the following key factors are shaping this environment. Other appropriate models and frameworks could be used, and appropriate credit would be given.

Bargaining power of buyers

NS is competing in two discrete market places. In the data communications component market it where it has less than 1% of the market share it is, at best, a supplier of marginal significance. The customers are OEMs, large industrial buyers who are likely to demand a testing combination of low prices, high quality and reliability. They are unlikely to tolerate the late delivery of orders. It appears that alternative sources of supply are readily available and that switching costs are relatively low. This combination of circumstances suggests that OEMs have significant bargaining power in this market place. This is particularly true for the OEM who currently accounts for 40% of NS' current sales.

In the second market place, where network management systems are supplied to large end users, the buyers appear to have less bargaining power. NS is catering for each customer's specific needs and so each solution is, to some degree, a bespoke solution. This makes it much harder for buyers to compare products and prices of potential suppliers, unlike in the commodity like data communication component market. Alternative sources of supply are much more difficult to find as there only two or three companies in this specialist marketplace. Furthermore, the product purchase is likely to represent a relatively small part of the buyer's overall investment in information and communication systems. Reduced bargaining power makes this product less price sensitive and so provides an opportunity to generate good margins. Large international customers are likely to be cautious about moving to new suppliers.

The bargaining power of suppliers

It seems unlikely that NS will be able to exert much influence on it suppliers. They are purchasing semiconductors and microprocessors from major global companies, who probably have well-known and powerful brands. NS, as a small company, will not have the power to exert buyer pressure on its suppliers, either in terms of price or delivery. Current problems associated with the delivery of components are having a significant impact on the company's ability to meet customer deadlines and expectations. Clearly an audit needs to be made of supplier performance and the opportunity, or otherwise, for NS to concentrate on suppliers able to deliver on time. However, for a small company like NS, the supplier appears to be in an excellent bargaining position.

If labour is seen as a supplier, then evidence again suggests that NS is in a relatively weak position. The scenario notes the difficulty of finding high calibre staff with NS's "small size and location making it difficult to attract the key personnel necessary for future growth".

Threats from new entrants

NS is operating in an industry where the costs of entry are significant because it is capital and knowledge intensive. NS has shown that there is a place for smaller innovative companies able to identify and exploit specialist market niches. Economies of scale compel new entrants to enter at significant output levels or suffer a cost disadvantage. The products are complex and there is likely to be a significant learning curve with costs only falling as volume builds up over time.

The need for government approval of new data communications components creates an approval process that is both lengthy and expensive and so creates a significant barrier to new entrants. New entrants may be discouraged by the uncertainty surrounding the industry, in terms of technology, user acceptance and the R&D investment necessary to create components and systems compatible with OEM's equipment and end user systems. Furthermore, the need to offer comprehensive aftersales support, although a problem for NS, does also create a significant barrier to new entrants.

Finally, the exit costs and barriers to exit in the shape of industry-specific knowledge, skills and assets reduce the attractiveness of the marketplace to new entrants.

Threats from substitutes

High technology industries are, by their very nature, prone to new technologies emerging that threaten and then eventually replace the established technology. Hence it is very important that companies in such industries constantly scan the external environment to identify and anticipate such threats. There is evidence that large, successful, high technology companies are particularly vulnerable to ignoring the challenge from disruptive new technologies. However, the small size of the NS may give it a competitive advantage in its ability to respond quickly and flexibly to change.

Rivalry amongst competitors

Very different levels of competition are being experienced in the two market places NS is operating in. Unfortunately the financial data given does not separate out the revenue and costs for each market place. However, it is clear that the high-volume, low-margin component business offers intense competition with buyers who are able to use their size to extract favourable prices. NS has less than 1% of the home market and there are over twenty competing suppliers, some of whom have significant international presence, with a dedicated, geographically distributed support team. The ability of NS to generate better market share and volumes through product innovation in this market seems highly unlikely. Competitive rivalry is high when there are many competing firms and the costs of leaving the industry are high.

The intensity of rivalry in the network management systems market is significantly less because there are only two or three competitors in this specialist market. NS is dealing with a small number of large end users, designing products specific to their needs. In Porter's terms, NS are adopting a focused differentiation strategy. In these low-volume, high-margin markers the emphasis has to be on increasing the volume side of the business, but at the same time making sure that they have the resources to handle new customers.

(c) The seven different positions on the social responsibility of business identified by Gray, Owen and Adams are as follows.

- **Pristine capitalists**. These individuals put self-interest before the collective benefits of society as a whole. They believe in ‘free market’ forces and argue that market forces will find solutions to major social problems such as the threat to the global environment.
- **Expedients**. These individuals take the view that companies cannot succeed in the long term unless they accept certain social responsibilities.
- **Proponents of the social contract**. These individuals believe that companies exist only through the goodwill of society and they therefore have an obligation to act in the interests of society. Government regulation is needed to restrain the damaging effects on society and the environment of free market forces.
- **Social ecologists**. These individuals take the view that problems in society and the environment have been created by companies, and it is therefore the responsibility of companies to admit their liability and solve the problems.
- **Socialists**. These individuals argue for a re-distribution of assets between members of society and against the concentration of resources and power in the hands of large organisations (companies and governments)
- **Radical feminists**. These individuals believe that there is too much male domination of society and too much aggression. More feminine values are needed, such as care and compassion.
- **Deep ecologists/ deep greens**. These individuals argue that human beings have no more right to life than any other living species. Ethical decisions should be based on a concern for all forms of life.

Individuals who work in business take the first two or three positions in the list, whereas many opponents of business and critics of unethical business practices take one of the last four positions in the list.

The analysis by Gray, Owen and Adams can be useful in adding to an understanding of ethical differences, and differing views about the morality of business. A better understanding of different ethical views can help individuals (managers and professional accountants) for search for solutions to disagreements.

Question 2

(a) Changes are required at Feathers Theatre if it is to survive and prosper. However, change is almost always resisted, and it will be no different at this theatre.

The reasons for resistance will be the same experienced in other organisations. There is always the fear of the unknown. How will the professional actors cope with the increased pressures associated with presenting more plays? How will audiences react to these changes?

The current situation is known and possibly understood. However the changes proposed may not operate in the ways intended and the situation may deteriorate. People also resist change if their vested interests are threatened. This is applicable to nearly all the stakeholders. There may be a switch to less satisfying and interesting plays. This will affect both the actors/ actresses as well as the volunteers, but for opposite reasons. The members of the town council might have some of their patronage removed and their prestige might be reduced. This would not be in their interests.

Change is also resisted if the stakeholders misinterpret the causes and consequences of the change. It is essential that David Manning has full consultation with all parties and clarifies all points. If any group of stakeholders believes it is being discriminated against, it will resist change. It is important to stress a 'win-win' situation and not a 'win-lose' one.

Ideally timing needs to be right to introduce changes. It is not usually desirable to have change forced on an organisation. However, it is possible that in a crisis, people will pull together and agree to compromise.

Change is also usually resisted if there are insufficient resources to help facilitate that change. Unfortunately Feathers Theatre does not have sufficient resources – this is the reason for the changes. Consequently, it is likely that some difficult decisions will have to be taken involving issues such as redundancies, possible pay reductions, higher ticket prices and a tight control over costs. These types of change will always be resisted. It is the strength of the resistance which is of critical importance.

Apart from economic fears, such as redundancies and pay cuts, there are a number of social reasons for resisting change. The volunteers may feel that their work is under-valued if their views are not taken into consideration. Members of the town council might believe that their status has been reduced if their opinions are not taken into account. This could have a serious impact on the way they view the theatre's grant. Requiring the resident acting group to change their method of working could imply a criticism as to their past performance. More important, however, is the breaking up of the group as a result of the proposed redundancies. There is probably going to be resistance here. This is likely to be the most delicate part of David Manning's negotiations. He has to demonstrate to the group that alternative strategies could involve even greater sacrifices.

Most of the reasons for resisting change could be challenged by open discussions. The facts must be made clear to all parties. A process of 'divide and rule' will only make the situation worse. David must state the position as it is. He must review the alternative strategies as presented by the stakeholders and show why and how they would not solve the problem. He must present his ideas for improving the situation, explaining how the changes could be implemented and what benefits and disadvantages may occur. Finally he must show how the situation will only deteriorate if nothing is done. Hopefully the stakeholders will appreciate the logic of his suggestions, and realise that they may all have to compromise on some but not all of their ambitions, and recognise that they still have an important role to play in the theatre.

(b) Implementing change successfully in an environment such as Feathers Theatre, where the participants all have differing ideas as to what should be done, requires leadership of a high quality. David Manning has one particular advantage. Being a new appointee he is not seen to be an ally of any particular stakeholder group. He is not associated with any strategies in the past, which have been badly implemented. He brings to the situation fresh and unbiased ideas. However, there is also a risk that some of the interested parties may feel that he has inadequate experience.

Mason must possess **good interpersonal skills**. He must be able to relate to all the parties, but must not be seen to treat one group more favourably than others. This may not be such an easy task because the different stakeholder groups, although all concerned with the success of the theatre, have different backgrounds, different objectives and will have different personalities. He must be a good communicator so that he can explain the changes so that each party sees the benefits for them. He must provide good information and not be selective. Usually the information leaks out via a 'grapevine' and this would only make the situation worse. Mason also needs to be able to time his negotiations correctly, so that the interested parties have an opportunity to listen to, reflect on and understand the varying arguments. In trying to do this when a stakeholder group, such as the actors, is concentrating on a performance, would be a big mistake. He must take time over the change programme. A ‘quick-fix’ attitude is not advisable.

Mason must prove to be both a **trustworthy and an inspirational leader**. If there is any doubt as to his commitment to the theatre, or if he is suspected of dishonestly representing their views, then his chances of winning the people over will be poor. It is a mistake to try to hide the truth, even if it is unwelcome. He needs to inspire each of the parties so that they are willing to subordinate their personal views for the benefit of the theatre as a whole. Good change agents also need to be opportunistic. This does not imply that they seek short-term advantages, but that when they see an opportunity to successfully accelerate the change, then they seize it. Mason must also have sound planning skills. Change does not just occur. If it is to be successfully achieved then it must be planned for. Unlikely outcomes must be considered, and contingency plans and explanations must be prepared.

Mason needs to demonstrate a **competence in team-building**. It is useful to get the stakeholders to participate together in the change programme. This involvement can increase the commitment of the groups by providing them with a sense of 'ownership'. He must monitor the progress of the change to ensure that it is actually happening. Some groups will find it harder to accept the changes required than others. Mason should recognise the need to provide support when this occurs and give counselling if necessary. The change will progress that much more effectively if the groups feel comfortable with the situation. If a favourable and positive climate can be created then change will be more readily effected.

Question 3

(a) *(**Tutorial note**: There is no single 'correct' answer to this question. The list of questions below is indicative of the questions that Robert Lam should ask.)*

Questions:

1. Does the company have a system for identifying risks (and if so, what is it)?
2. Does the company have a system for assessing risks and prioritising risks?
3. Does the company actively manage its risks?
4. Has the board of directors communicated to management what levels of risk are acceptable? (Or: Has the board formulated and communicated a clear policy on risk and risk management?)
5. Has the board of directors identified the limits of its 'risk appetite'?
6. Should certain risks be taken at all, or should they be avoided? (Or: Should the exposure to certain risks be increased/reduced?)
7. Do independent non-executive directors occasionally select and challenge operational risk reports and investment decisions by management?

(b) **Exposure to risk**.

All business activities involve some risks and whenever a risk exists, there is an exposure to that risk. This means that the actual outcome might be worse (or better) than expected. For example if a company makes a strategic capital investment, there is a risk that the investment will make a loss, or will fail to provide an adequate return.

With credit risk, there is a possibility that when a company gives credit to its customers, the customer might fail to pay what he owes, and there will be a bad debt. With credit risk, the total exposure to risk can be measured as the total amount of receivables.

Risk of losses.

When a business entity has exposures to risk, there is a risk that some unexpected losses will occur if adverse events occur. The amount of the loss that might occur is rarely the full amount of the exposure. For example, if a company has an exposure to bad debts, with receivables of ₦10 million, it is most unlikely that all the receivables will become bad debts. Even when a customer becomes a bad debt, some of the debt might be recovered in legal proceedings. The risk of losses is an estimate of what the losses might be from a given exposure to risk.

The risk of losses cannot always be measured, but with credit risk, it might be possible to estimate the risk of losses from an exposure to credit risk as:

Total exposure (= total receivables) × Probability of default × Loss in the event of a default

For example, if a company has ₦10 million of annual sales, there is a 2% probability of default and in the event of default by a customer only (on average) 25% of the debt will be recovered, the risk of losses is:

₦10 million × 2% × 75% = ₦150,000.

Residual risk.

Residual risk is the risk of losses after allowing for all risk control measures to reduce or contain the risk. In the case of bad debt risk, the risk might be reduced through better credit-checking procedures, or more efficient debt collection procedures. The finance director of Basket Company thinks that the bad debt risk can be reduced by improving debt collection procedures. If the probability of default could be reduced to, say, 1.8%, and sales will increase by 20% each year to ₦12 million, the risk of losses would be reduced to ₦12 million × 1.8% × 75% = ₦162,000.

Risk appetite.

Risk appetite describes the amount of risk (losses) that an entity is prepared to accept in order to obtain the expected benefits. In this example, if the company is willing to increase the credit period allowed to customers from 30 days to 60 days, the risk of annual losses from bad debts will rise from ₦150,000 to ₦162,000.

The company must decide whether it has the ‘appetite’ to accept the risk of losses of ₦162,000 in order to obtain the benefits of higher annual sales (₦2 million) and the additional profits from those sales.

Question 4

(a) In a unitary board structure, there is a single board of directors. In a two-tier structure, there are two boards of directors: a management board of executive directors and a supervisory board of non-executive directors. The management board has the authority to take some business decisions and the supervisory board is responsible for other board-level decisions by the company.

The main advantages of a unitary board structure are as follows.

- The executive directors and non-executive directors meet together and are jointly responsible for all the decisions of the board. They can all contribute their skills and experience to decision-making.
- Non-executive directors can influence business strategy more directly than in companies with a two-tier structure, where many strategic decisions are taken by the management board. With a unitary board structure, non-executive directors can therefore be more effective in using their knowledge and experience to contribute to decision-making by the board.
- Since all board decisions are taken by a single board, all the directors are jointly accountable to the shareholders. Accountability of the directors to the shareholders is a key feature of good corporate governance.
- In a two-tier board structure, the chairman and CEO are very powerful individuals, even more so than in companies with a unitary board. With a unitary board. The NEDs are able to exert more influence, and so help to achieve a better balance of power.

The main disadvantages of a unitary board are as follows.

- It is usual for unitary boards to have a majority of independent NEDs. For example, this is a requirement for large listed companies in the UK. If any NEDs represent a particular interest, such as a major shareholder or the employees of the company, they are not independent: the board will need be quite large if it is to have a majority of independent NEDs.

The requirement in Nigeria is that at least one director must be independent.

- Two-tier boards make it much easier to appoint directors who represent particular interests, such as the interests of employees. This has advantages as well as disadvantages. The advantage of having non-independent NEDs is that the supervisory board can represent more stakeholder groups. A stakeholder approach to corporate governance is a valid alternative to a shareholder-focused approach.
- On a unitary board, NEDs are both colleagues of their executive director colleagues, but also supervisors or 'policemen' with the task of preventing executive directors from running the company in their own interests rather than those of the shareholders. With a two-tier board, the supervisory board (as its name suggests) has a supervisory role over executive directors. Directors on the supervisory board are not required to mix the roles of 'colleague' and 'policeman'.

(b) Mr Lund's remunerations package

Different components of directors' rewards

- The components of a director's total rewards package may include any or all of the following in combination.
- The basic salary is not linked to performance in the short run but year-to-year changes in it may be linked to some performance measures. It is intended to recognise the basic market value of a director.
- A number of benefits in kind may be used which will vary by position and type of organisation, but typically include company cars, health insurance, use of health or leisure facilities, subsidised or free use of company products (if appropriate), etc.
- Pension contributions are paid by most responsible employers, but separate directors' schemes may be made available at higher contribution rates than other employees.
- Finally, various types of incentives and performance related components may be used. Short to medium term incentives such as performance-related annual bonuses will encourage a relatively short term approach to meeting agreed targets whilst long term incentives including share options can be used for longer term performance measures.

Mr Lund's remuneration package

- The case mentions that, "Mr Lund's remuneration package as a sales director was considered to be poorly aligned to Groover's interests because it was too much weighted by basic pay and contained inadequate levels of incentive."
- The alignment of director and shareholder interests occurs through a careful design of the performance related components of a director's overall rewards. The strategic emphases of the business can be built

into these targets and Mr Lund's position as a sales director makes this possible through incentives based on revenue or profit targets.

- If current priorities are for the maximisation of relatively short-run returns, annual, semi-annual or even monthly performance-related bonuses could be used. More likely at board level, however, will be a need for longer-term alignments for medium to long-term value maximisation.
- While Mr Lund may be given annual or even quarterly or monthly bonus payments against budget, longer-term performance can be underpinned through share options with a relevant maturity date or end-of-service pay-outs with agreed targets.
- The balance of short and longer-term performance bonuses should be carefully designed for each director with metrics within the control of the director in question.

(c) Evaluation of the proposal from Hannover House.

- The dilemma over what action to take in the light of Mr Ng and Mr Lund's cross directorship is a typical problem when deciding how to address issues of conflicts of interest. Should the situation be 'put right' at minimum cost, or should the parties in the arrangement be punished in some way as Hannover House suggested?
- Groover's more equivocal suggestion (that the remunerations committee reconsider Mr Lund's remuneration package without Mr Ng being present) may be more acceptable to some shareholders.
- This debate touches on the ethical issues of a pragmatic approach to some issues compared to a dogmatic approach.

For the proposal

- Hannover House's more radical proposal would have a number of potential advantages. Specifically, it could be argued that the resignation of both men from their respective NED positions would restore LMN shareholders' confidence in the remunerations committee. The appearance of probity is sometimes as important as the substance and resignations can sometimes serve to purge a problem to everybody's (except for the director in question's) benefit.
- The double resignation would signal a clean break in the apparently compromising relationship between Mr Lund and Mr Ng and, certainly as far as LMN was concerned, would resolve the problem decisively. It would signal the importance that LMN placed on compliance with corporate governance best practice and this, in turn, would be of comfort to shareholders and analysts concerned with the threat to the independence of LMN's remunerations committee.

Against the proposal

- Hannover House's proposal was seen as too radical for Groover. Among its concerns was the belief that only Mr Ng's resignation from LMN's remunerations committee would be strictly necessary to defuse the situation. Clearly Groover saw no problem with Mr Lund's position on the LMN board in his executive capacity.

- Furthermore, it took a pragmatic view of Mr Ng's position as NED on LMN's board. It considered Mr Ng's input to be valuable on the LMN board and pointed out that this input would be lost if Hannover House's proposal was put into practice. Hannover House may therefore have been mindful of the assumed deficit of talent at senior strategic level in corporate management and accordingly, wished to retain both Mr Lund's and Mr Ng's expertise if at all possible.

Note that in some countries, cross-directorships are not 'malpractice' (as suggested in the scenario) even if they are not good corporate governance practice.

Question 5

(a) GG plc and a 'sound' system of internal control

Features of sound control systems

It is insufficient to simply 'have' an internal control system. They can be effective and serve the aim of corporate governance or they can be ineffective and fail to support them. In order to reinforce 'soundness' or effectiveness, systems need to possess a number of features.

Firstly, the principles of internal control should be embedded within the organisation's structures, procedures and culture. Internal control should not be seen as a stand-alone set of activities and by embedding it into the fabric of the organisation's infrastructure, awareness of internal control issues becomes everybody's business, and this contributes to effectiveness.

Secondly, internal control systems should be capable of responding quickly to evolving risks to the business arising from factors within the company and to changes in the business environment. The speed of reaction is an important feature of almost all control systems (for example a servo system for vehicle brakes or the thermostat on a heating system). Any change in the risk profile or environment of the organisation will necessitate a change in the system and a failure or slowness to respond may increase the vulnerability to internal or external trauma.

Thirdly, sound internal control systems include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified, together with details of corrective action being undertaken. Information flows to relevant levels of management capable and empowered to act on the information are essential in internal control systems. Any failure, frustration, distortion or obfuscation of information flows can compromise the system. For this reason, formal and relatively rigorous information channels are often instituted in organisations seeking to maximise the effectiveness of their internal control systems.

Shortcomings at GG plc.

The case highlights a number of ways in which the internal control at GG fell short of that expected of a 'sound' internal control system.

First, and most importantly, the case suggests that the culture of GG did not support good internal control. Miss Jenkins made reference to, "culture of carelessness in GG" and said that the issue over the fire safety standards "was only one example of the way the company approached issues such as international fire safety standards." While having systems in place to support sound internal control, it is also important to have a culture that also places a high priority on it.

Second, there is evidence of a lack of internal control and reporting procedures at GG. Not only was the incorrect fire-rating labelling not corrected by senior management, the attempt to bring the matter to the attention of management was also not well-received.

Third, there is evidence of structural/premeditated contravention of standards (and financial standards) at GG. In addition to the fire safety issue, the case makes reference to a qualified audit statement over issues of compliance with financial standards. There is ample evidence for shareholders to question the competence of management's ability to manage the internal control systems at GG.

(b) Reputation risk

Defining reputation risk

Reputation risk is one of the categories of risk used in organisations. It is identified as a risk category in the Nigerian Corporate Governance Code and a number of events in various parts of the world have highlighted the importance of this risk. Reputation risk concerns any kind of deterioration in the way in which the organisation is perceived, usually, but not exclusively, from the point of view of external stakeholders. The cause of such deterioration may be due to irregular behaviour, compliance failure or similar, but in any event, the effect is an aspect of corporate behaviour below that expected by one or more stakeholder. When the 'disappointed' stakeholder has contractual power over the organisation, the cost of the reputation risk may be material.

Effects of poor reputation on financial situation

There are several potential effects of reputation risk on an affected organisation. When more than one stakeholder group has reason to question the otherwise good reputation of an organisation, the effect can be a downward spiral leading to a general lack of confidence which, in turn, can have unfortunate financial effects. In particular, however, reputation risk is likely to affect one or more of the organisation's interactions with resource providers, product buyers, investors or auditors/regulators. Resource provision (linked to resource dependency theory) may affect recruitment, financing or the ability to obtain other inputs such as (in extremis) real estate, stock or intellectual capital. Within product markets, damage to reputation can reduce confidence among customers leading to reduced sales values and volumes and, in extreme cases, boycotts. Investor confidence is important in public companies where any reputation risk is likely to be reflected in market value. Finally, auditors, representing the interests of shareholders, would have reason to exercise increased scrutiny if, say, there are problems with issues of trust in a company. It would be a similar situation if the affected organisation were in an industry subject to high levels of regulation.

GG and reputation

At GG, the sources of the potential threat to its reputation arise from a failure to meet an external standard, an issue over product confidence and a qualified audit statement. The failure to meet an external standard concerned compliance with international fire safety standards. The issue over product confidence involved selling one product falsely rated higher than the reality. These would be likely to affect customer confidence and the attitude of any fire safety accrediting body. The qualified audit statement would be likely to intensify the attention to detail paid by auditors in subsequent years.

(c) A rules-based code of ethics is one in which detailed rules are specified about the way in which professional accountants must behave or act in particular circumstances.

In practice, there are many different situations, with differing circumstances, where accountants might have an ethical dilemma. It would be difficult to foresee every type of situation and specify the exact rule for each. The appropriate resolution of an ethical problem might also vary between countries, according to the differing cultures and ethical outlook of each country.

For this reason, except where particular behaviour is required from accountants by the law (for example, with regard to reporting suspicions of money laundering activities by a client), accountants are required to act in accordance with a principles-based code of ethics.

The code of ethics for accountants requires compliance with five fundamental ethical principles: integrity, objectivity, professional competence and due care, confidentiality and professional behaviour and care.

(d) Ethical responsibilities of a professional accountant

A professional accountant has two ‘directions’ of responsibility: one to his or her employer and another to the highest standards of professionalism.

Responsibilities to employer

An accountant’s responsibilities to his or her employer extend to acting with diligence, probity and with the highest standards of care in all situations. In addition, however, an employer might reasonably expect the accountant to observe employee confidentiality as far as possible. In most situations, this will extend to absolute discretion of all sensitive matters both during and after the period of employment. The responsibilities also include the expectation that the accountant will act in shareholders’ interests as far as possible and that he or she will show loyalty within the bounds of legal and ethical good practice.

Responsibilities as a professional

In addition to an accountant’s responsibilities to his or her employer, there is a further set of expectations arising from his or her membership of the accounting profession.

In the first instance, professional accountants are expected to observe the letter and spirit of the law in detail and of professional ethical codes where applicable (depending on country of residence, qualifying body, etc.). In any professional or ethical situation where codes do not clearly apply, a professional accountant should apply ‘principles-based’ ethical standards (such as integrity and probity) such that they would be happy to account for their behaviour if so required.

Finally, and in common with members of other professions, accountants are required to act in the public interest that may, in extremis, involve reporting an errant employer to the relevant authorities. This may be the situation that an accountant may find him or herself in at GG. It would clearly be unacceptable to be involved in any form of deceit and it would be the accountant's duty to help to correct such malpractice if at all possible.

Question 6

(a) **Deontology and consequentialism**

Deontological ethics

The deontological perspective can be broadly understood in terms of 'means' being more important than 'ends'. It is broadly based on Kantian (categorical imperative) ethics. The rightness of an action is judged by its intrinsic virtue and thus morality is seen as absolute and not situational. An action is right if it would, by its general adoption, be of net benefit to society. Lying, for example, is deemed to be ethically wrong because lying, if adopted in all situations, would lead to the deterioration of society.

Consequentialist ethics

The consequentialist or teleological perspective is based on utilitarian or egoist ethics meaning that the rightness of an action is judged by the quality of the outcome. From the egoist perspective, the quality of the outcome refers to the individual ("what is best for me?"). Utilitarianism measures the quality of outcome in terms of the greatest happiness of the greatest number ("what is best for the majority?"). Consequentialist ethics are therefore situational and contingent, and not absolute.

(b) **Integrity**

Meaning of 'integrity'

Integrity is generally understood to describe a person of high moral virtue. A person of integrity is one who observes a steadfast adherence to a strict moral or ethical code notwithstanding any other pressures on him or her to act otherwise. In professional life, integrity describes the personal ethical position of the highest standards of professionalism and probity. It is an underlying and underpinning principle of corporate governance and it is required that all those representing shareholder interests in agency relationships both possess and exercise absolute integrity at all times. To fail to do so is a breach of the agency trust relationship.

Importance of integrity in corporate governance

Integrity is important in corporate governance for several reasons. Codes of ethics do not capture all ethical situations and the importance of the virtue of the actor rather than the ethics of the action is therefore emphasised. Any profession (such as accounting) relies upon a public perception of competence and integrity and in this regard, accounting can perhaps be compared with medicine. As an underlying principle, integrity provides a basic ethical framework to guide an accountant's professional and personal life.

Integrity underpins the relationships that an accountant has with his or her clients, auditors and other colleagues. Trust is vital in the normal conduct of these relationships and integrity underpins this.

(c) **Professor Li's views on codes of professional ethics**

Professor Li adopts a sceptical stance with regard to codes of ethics. There are arguments both supporting and challenging his views.

Supporting Professor Li's opinion

Professional codes of ethics have a number of limitations, some of which Professor Li referred to. Because they contain descriptions of situations that accountants might encounter, they can convey the (false) impression that professional ethics can be reduced to a set of rules contained in a code (as pointed out by Professor Li).

This would be a mistaken impression, of course, as the need for personal integrity is also emphasised. Ethical codes do not and cannot capture all ethical circumstances and dilemmas that a professional accountant will encounter in his or her career and this reinforces the need for accountants to understand the underlying ethical principles of probity, integrity, openness, transparency and fairness.

Although codes such as IFAC's are intended to apply to an international 'audience', some may argue that regional variations in cultural, social and ethical norms mean that such codes cannot capture important differences in emphasis in some parts of the world. The moral 'right' can be prescribed in every situation.

Finally, professional codes of ethics are not technically enforceable in any legal manner although sanctions exist for gross breach of the code in some jurisdictions. Individual observance of ethical codes is effectively voluntary in most circumstances.

Against Professor Li's opinion

There are a number of arguments for codes of professional ethics that challenge Professor Li's views. Firstly, professional codes of ethics signal the importance, to accountants, of ethics and acting in the public interest in the professional accounting environment. They are reminded, unambiguously and in 'black and white' for example, that as with other professions, accounting exists to serve the public good and public support for the profession is likely to exist only as long as the public interest is supported over and above competing interests.

The major international codes (such as IFAC's Code of Ethics and Nigeria's Code of Professional Conduct) underpin national and regional cultures with internationally expected standards that, the codes insist, supersede any national ethical nuances. The IFAC code states, "the accountancy profession throughout the world operates in an environment with different cultures and regulatory requirements. The basic intent of the Code, however, should always be respected."

The codes prescribe minimum standards of behaviour expected in given situations and give specific examples of potentially problematic areas in accounting practice. In such situations, the codes make the preferred course of action unambiguous.

A number of codes of ethics exist for professional accountants. Prominent among these is the IFAC code. This places the public interest at the heart of the ethical conduct of accountants. The Nigerian code discusses ethics from within a principles-based perspective. Other countries' own professional accounting bodies have issued their own codes of ethics in the belief that they may better describe the ethical situations in those countries.